



# **Non-Bank Financial Institutions: Regulation For Development**

**USAID SEGIR Annual Meeting**

**11 December 2002**

# Overview

- **Why are NBFIs Important?**
- **Where are they in development?**
- **Assumptions for NBFI Regulation**
- **Framework for Supervision**
- **Lessons Learned**
- **Mauritius – Regulation for Development**

# Why Are NBFIs Important?

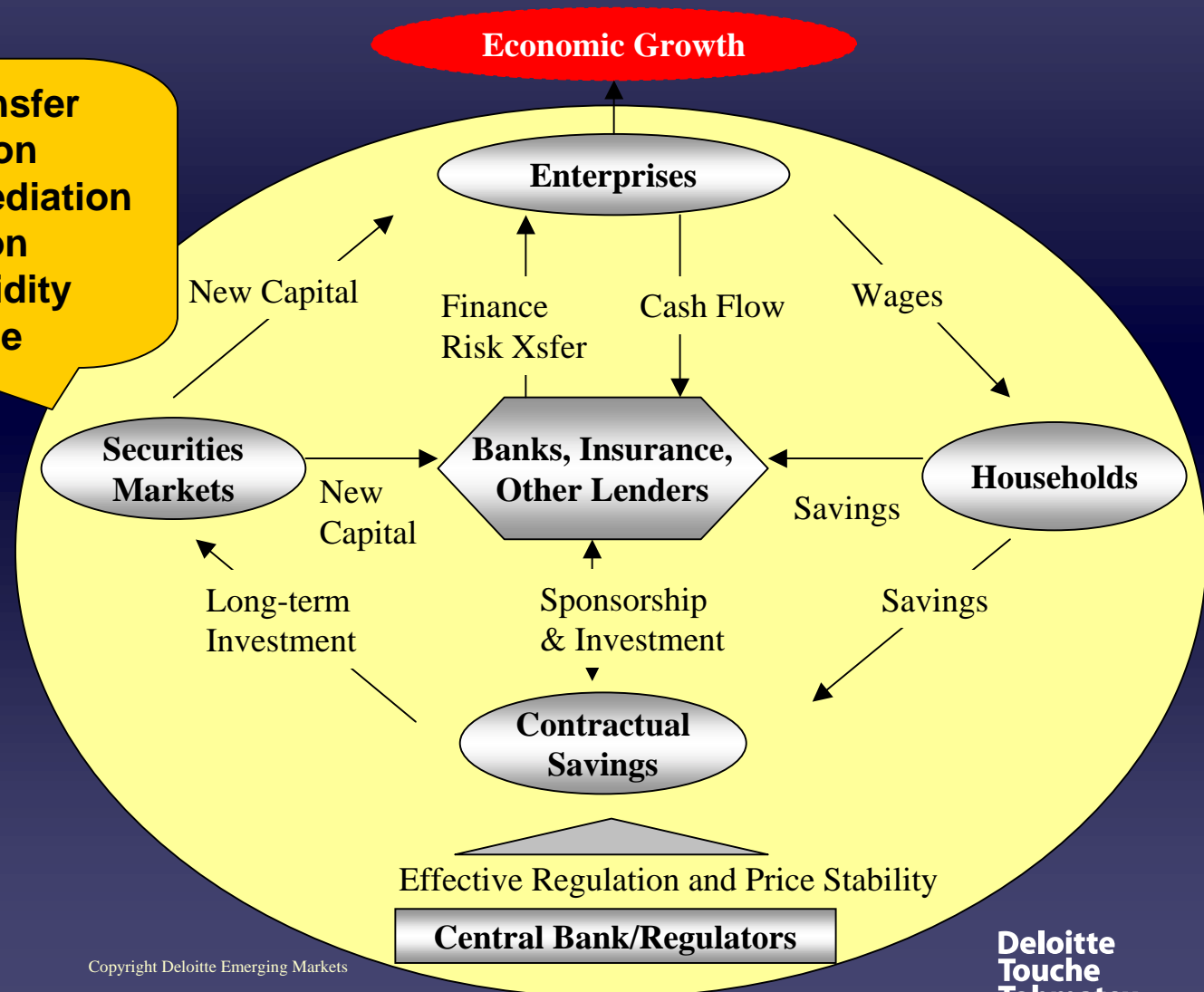
NBFI's	Role in financial sector ...
Insurance (Life and General)	<ul style="list-style-type: none"><li>▪ Household Stability</li><li>▪ Savings Mobilization</li><li>▪ Transfer Risk - Support Trade/Commerce</li></ul>
Mutual/Pension Funds	<ul style="list-style-type: none"><li>▪ Savings Mobilization</li><li>▪ Resource Allocation</li><li>▪ Add Depth/Liquidity to Financial Mkts</li></ul>
Securities Markets	<ul style="list-style-type: none"><li>▪ Alternative Intermediation</li><li>▪ Spur Competition</li><li>▪ Savings Mobilization</li></ul>
Brokers/Dealers	<ul style="list-style-type: none"><li>▪ Execute Transactions</li><li>▪ Market Make</li><li>▪ Add Liquidity</li></ul>
Credit Coops/Finance Cos/Leasing	<ul style="list-style-type: none"><li>▪ Alternative Sources of Finance</li><li>▪ Under-served Niches/Areas</li><li>▪ Broaden Financial Markets</li></ul>

# Financial Intermediation at 10,000 ft.

## NBFIs ...

- ✓ Risk Bundling/Transfer
- ✓ Savings Mobilization
- ✓ Alternative Intermediation
- ✓ Resource Allocation
- ✓ Market Depth/Liquidity
- ✓ Specialized Finance

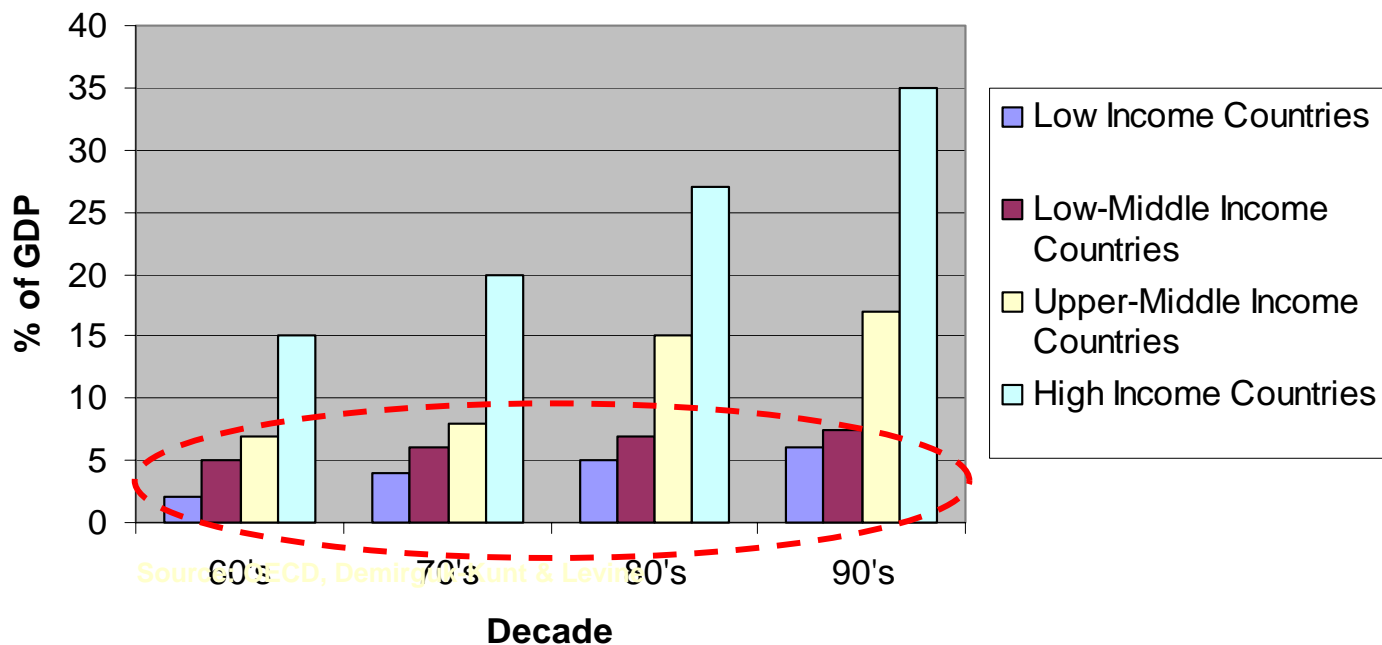
“Spare Tires”  
contribute to  
stability



# Relative Position of NBFIs Around the World

Role/importance of banks diminish somewhat as economies grow

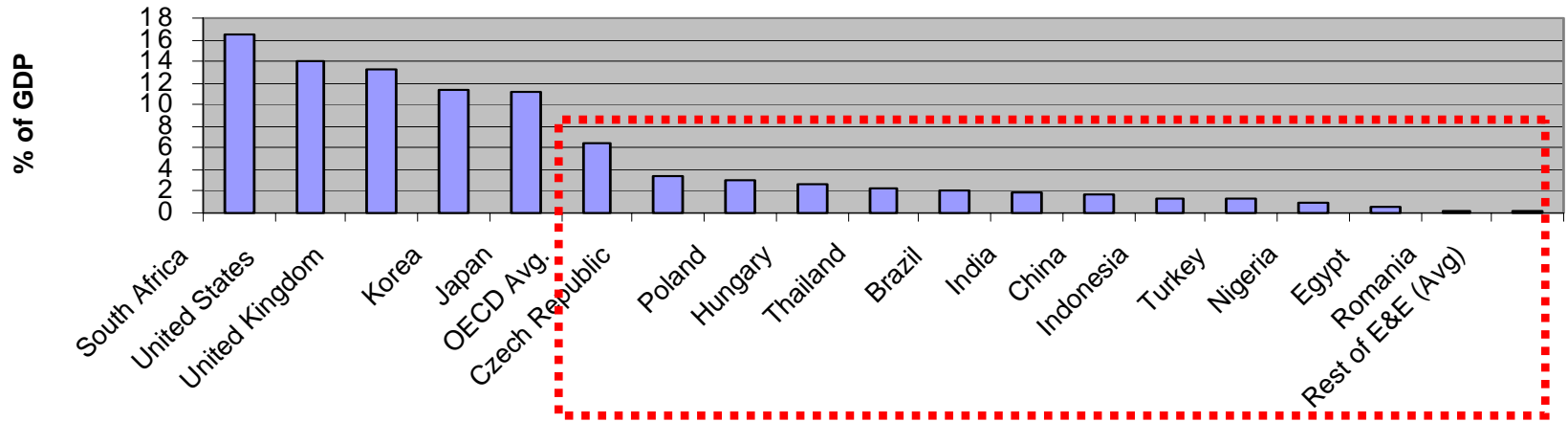
**Claims By Non-banks Towards Private Sector/GDP (Cross-Section of 155 Countries)**



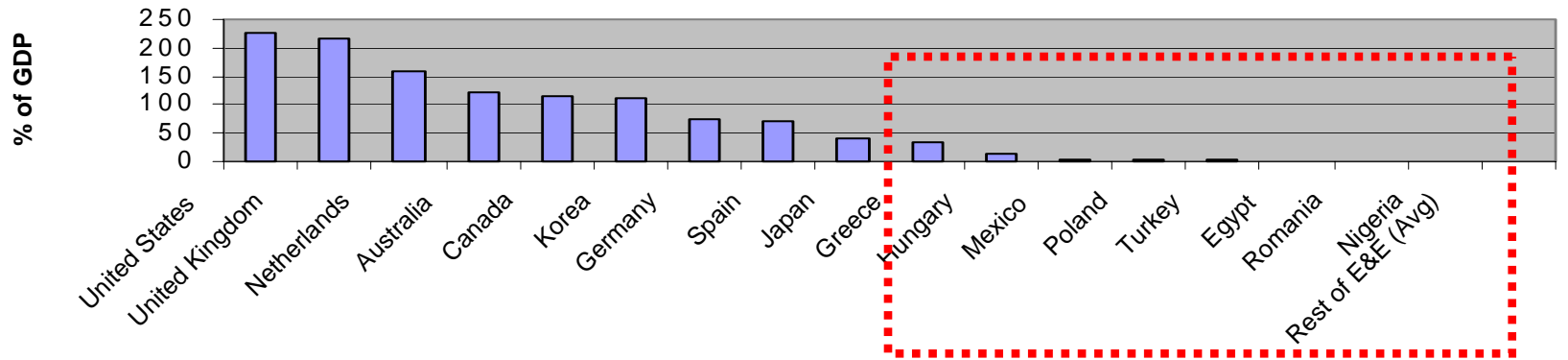
Source: ECD, Demirgüç-Kunt & Levine

# Penetration of Insurance and Contractual Savings

## Penetration of Insurance (Life and General)



## Financial Assets Held By Contractual Savings Institutions (Pensions, Life Insurance, Mutual Funds)



# Development Factors

**Varied, inter-dependent, and different than for banks**

NBFI's	Development Factors
<b>Insurance (Life and General)</b>	<ul style="list-style-type: none"><li>• Savings, mkt depth, inflation, other vehicles</li><li>• Urbanization, family structure, religion, savings culture</li><li>• Tax policy, pension policies</li></ul>
<b>Mutual/Pension Funds</b>	<ul style="list-style-type: none"><li>• Existence of govt pension/safety nets, depth of stock market</li><li>• Market integrity</li><li>• Tax incentives</li></ul>
<b>Securities Markets Brokers/Dealers</b>	<ul style="list-style-type: none"><li>• Depository, trading system, clearing/settlement</li><li>• Disclosure, conduct of business, clear mandate</li><li>• Institutional investors</li></ul>
<b>Credit Coops/Finance Cos/ Leasing</b>	<ul style="list-style-type: none"><li>• Sources of wholesale finance</li><li>• Market-oriented legal framework, regulatory gaps</li><li>• Reach of banking system</li></ul>

# Some Differences Among Regions

- Bank-based systems
- Weak legacy of NBFIs services
- Some growth, but slow development

- Strong (arbitrage) growth, but under-regulated.
- Contributed to crises in Thailand, Korea, Malaysia, Japan

- NBFIs evolved to fill gaps in bank-based systems (inflation and reach)
- Legacy of state-ownership
- Systemic underdevelopment





# Development can go wrong ...

<b>Thailand</b>	<ul style="list-style-type: none"><li>• Systemic risk from finance companies were catalysts of crises.</li></ul>
<b>Singapore</b>	<ul style="list-style-type: none"><li>• Barings collapse from unauthorized trading by subsidiary.</li></ul>
<b>Japan</b>	<ul style="list-style-type: none"><li>• Strain on banking system from finance company subsidiaries.</li></ul>
<b>Korea</b>	<ul style="list-style-type: none"><li>• Merchant banks and trust funds as secondary banks</li><li>• Leasing and life insurance as secondary banking systems</li></ul>
<b>Brazil/Phillipines</b>	<ul style="list-style-type: none"><li>• Pre-need institutions go unregulated yet extend commitments many years into future.</li></ul>
<b>United States</b>	<ul style="list-style-type: none"><li>• LTCM collapse over derivatives leverage rocked the financial system for days.</li></ul>
<b>Albania</b>	<ul style="list-style-type: none"><li>• Failed pyramid schemes put country in crises</li></ul>

# Regulatory Issues

- Historically, no coherent approach to NBFIs regulation (different roles; different risks; different perceptions; patchwork evolution)
- Regulation towards application of individual laws created in a policy/sector strategy vacuum.
- Capacity-building reform around skill-building, organizational design and standards implementation.
- Enforcement mechanisms weak and inflexible
- NBFIs development sensitive to regulation – burden vs. efficiency
- Role in money laundering under scrutiny ... these days

**Question: How should NBFIs be regulated for efficiency and development**

# Important Assumptions for NBFI Regulation Design

- **Neutrality** in regulation among financial intermediaries is key to avoid unsound/fettered development.
- Not all institutions need to be regulated alike: **differentiation** of risks and policies.
- Intensity of supervision should be *scaled* by the degree of risk - **proportionality**
- **Coordination** of regulation towards different objectives – i.e. for safety and soundness, market conduct, and consumer protection
- The **incentives** have to be in line.
- Effective regulation is **holistic**.
- Regulation should not seek to avoid all failure – **tolerance** limits driven by policy

# Integrated Framework for Regulation

## Set Objectives

### Objectives (Indicative)

- ✓ Safety and Soundness
- ✓ Market Integrity
- ✓ Protect Users of Fin Svcs
- ✓ Other Policy Decisions

### Principles

- ✓ Neutrality
- ✓ Proportionality
- ✓ Cost Effective
- ✓ Leverage Mkt Discipline
- ✓ Leverage Self-Regulation

## Design Tools

Prudential Standards

Enforcement  
Regime

Market Conduct Rules

Disclosure

Market Structure  
Requirements

Entry Requirements

## Apply Regulation

Regulate Towards Objectives

Securities Markets

Insurance Markets

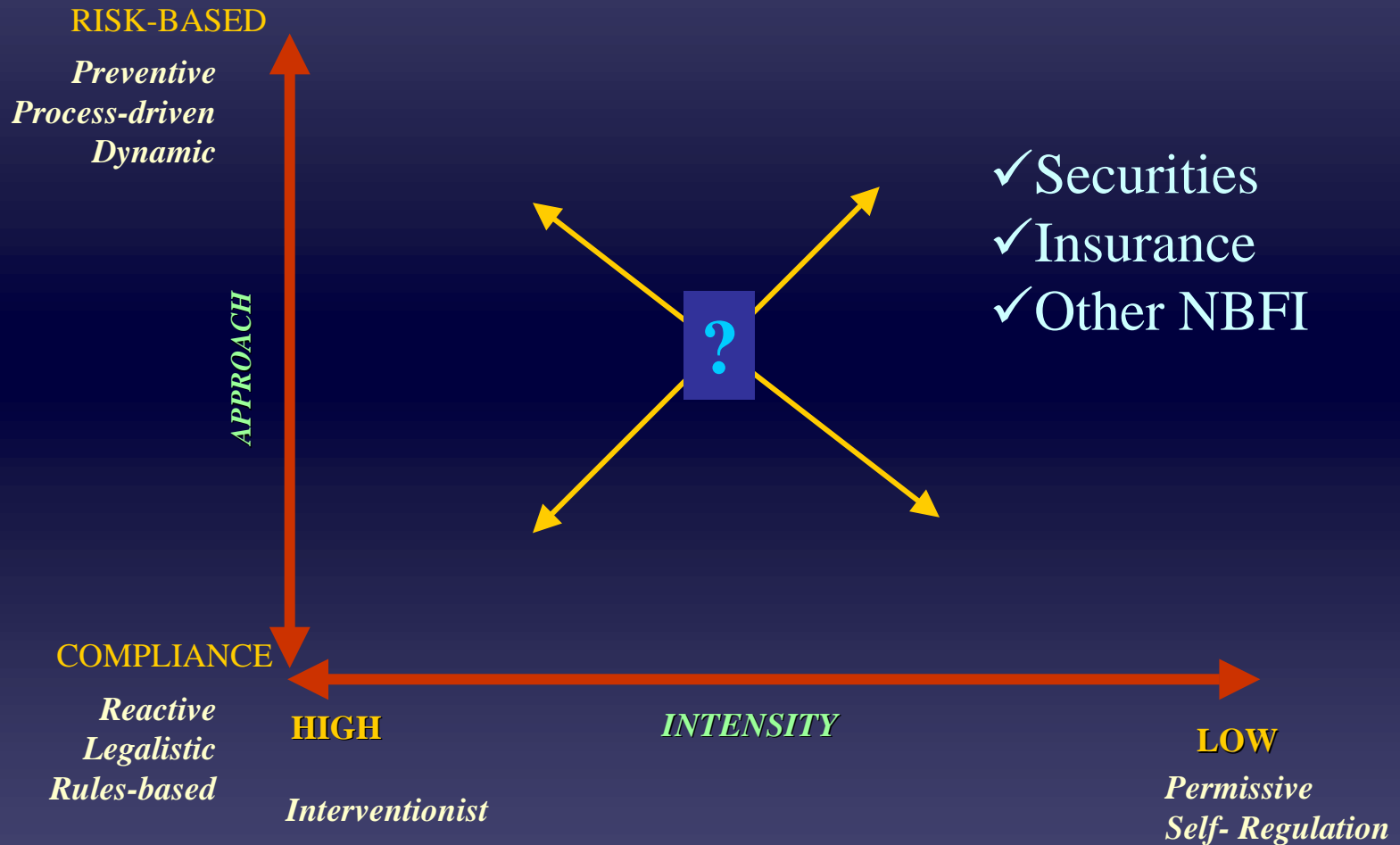
Contractual Savings

Other NBFI

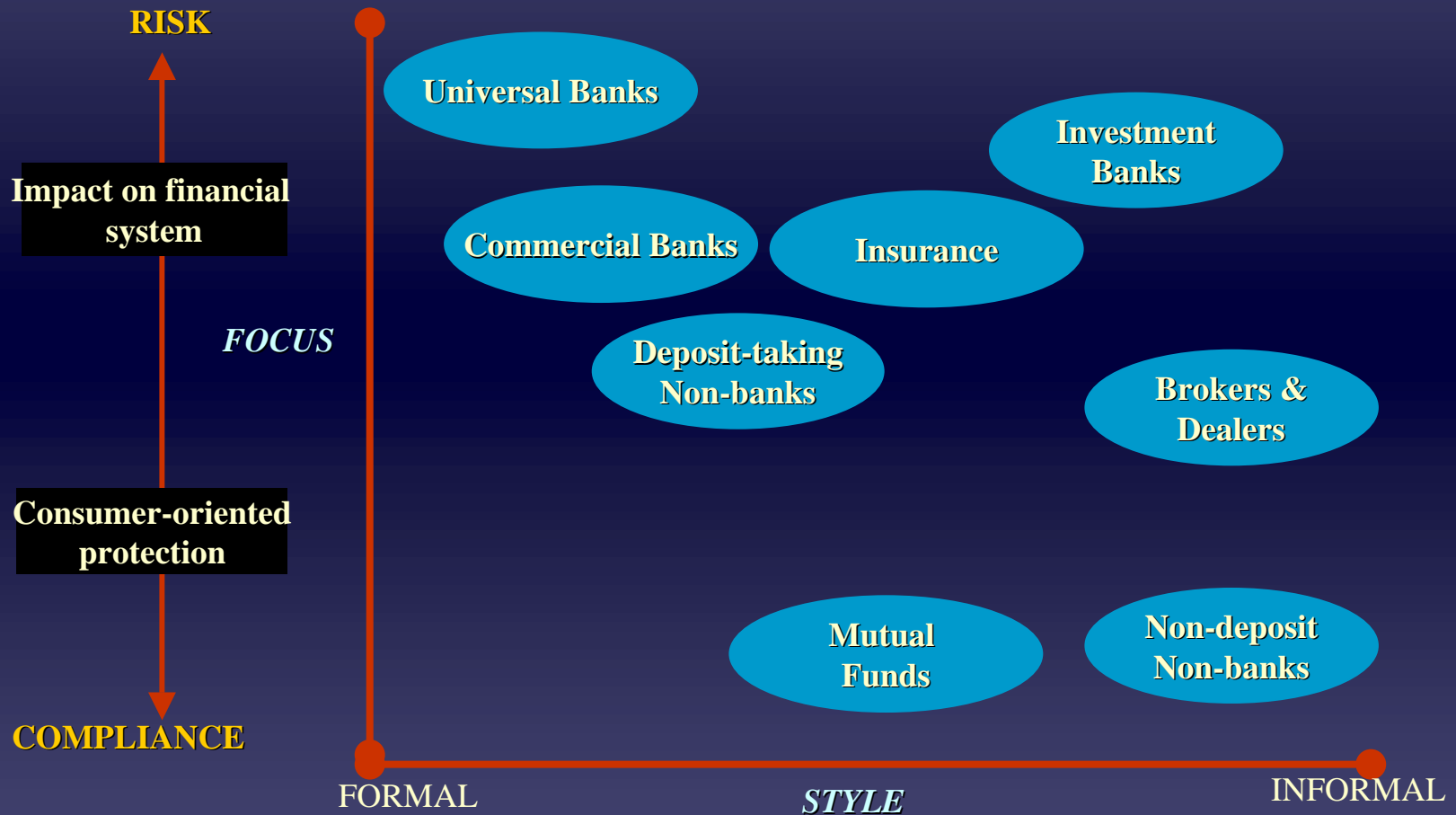
Banks

Intensity of  
Regulation  
Scaled  
By Degree  
of Risk

# Calibrating Supervision



# Calibrated Supervision (Indicative)



# Organization for Regulation

- Institutional
- Functional
- Inegrated

# Organizational Designs around the World

	Banking	Securities	Insurance
<i>Brazil</i>	CB	CB/S	I
<i>Argentina</i>	B	S	I
<i>Chile</i>	B	SI	
<i>Venezuela</i>	B	S	I
<i>Mexico</i>	BS		I
<i>Spain</i>	CB	S	I
<i>Peru</i>	BI	S	BI
<i>Belgium</i>	BS		I
<i>Denmark</i>	SSA		
<i>Germany</i>	B	S	I
<i>France</i>	B/CB	S	I
<i>Ireland</i>	CB	S	G
<i>Netherlands</i>	CB	S	I
<i>Austria</i>	G	G	G
<i>Sweden</i>	SSA		
<i>United Kingdom</i>	SSA		I
<i>Switzerland</i>	BS		I
<i>Czech Republic</i>	CB	SI	
<i>Hungary</i>	B	SI	
<i>Poland</i>	CB	S	I
<i>Slovenia</i>	CB	S	G
<i>United States</i>	CB	S	I
<i>Japan</i>	SSA		

BS = Banking and Securities Supervisor

CB = Central Bank

SSA = Single Financial Supervisory Authority

B = Specialized Banking Supervisor

BI = Banking and Insurance Supervisor

S = Specialized Securities Supervisor

I = Specialized Insurance Supervisor

G = Government Department

SI = Securities and Insurance Supervisor



# Implementing TA: Lessons from Practice

- Policy coherency
- Address root causes
- Consensus build (industry consultation, MOU, stakeholder map)
- Develop a rigorous (sound policy-based) framework for sequencing
- *Train* – don't just educate
- Build in more routine assessment of progress
- Engage counterparts from Day One
- Be Activist
- Tailor the approach - one size does not fit all

# Implementing TA: Discernable Needs of Donor Countries

- Policy setting and objective setting advisory – sorting through the issues
- Developing coherent frameworks for regulation
- Best Practice Standards for Integrated NBFI Regulation
- Policy frameworks for harmonization of NBFI regulations
- Public consultation processes
- Development of supervisory cooperation agreements
- Training in the *application* of regulation
- Enforcement, enforcement, enforcement



# Case of Mauritius

# Creation of an integrated NBFIs regulator

- **Broaden economic base in FS to serve region**
- **Fill regulatory gaps in NBFIs sector**
- **Fill regulatory gaps in offshore industry**
- **Harmonize regulatory process among banks and NBFIs**
- **Develop FS promotional agency**

# Regulatory Structure for Financial Sector

## FSD Act

### Securities

- Unit Trust Act
- SE Act 1988
- SE Regs 1988
- SE Trading Procedures
- Listing Rules
- CDS Procedures Manual
- CDS Rules
- CDS Procedures Guarantee Fund
- Conduct of Trading Rules
- Securities Law (In process)*
- Collective Investment Scheme Act (In process)*

### Insurance

- Insurance Act 1987
- Insurance Regulations
- Life Insurance & Pension Act (In process)*
- General Insurance Act (In process)*

### Other NBFIs

- Leasing Act (In process)*
- Law on Factoring (In process)*
- Pensions Fund Act for Statutory Bodies

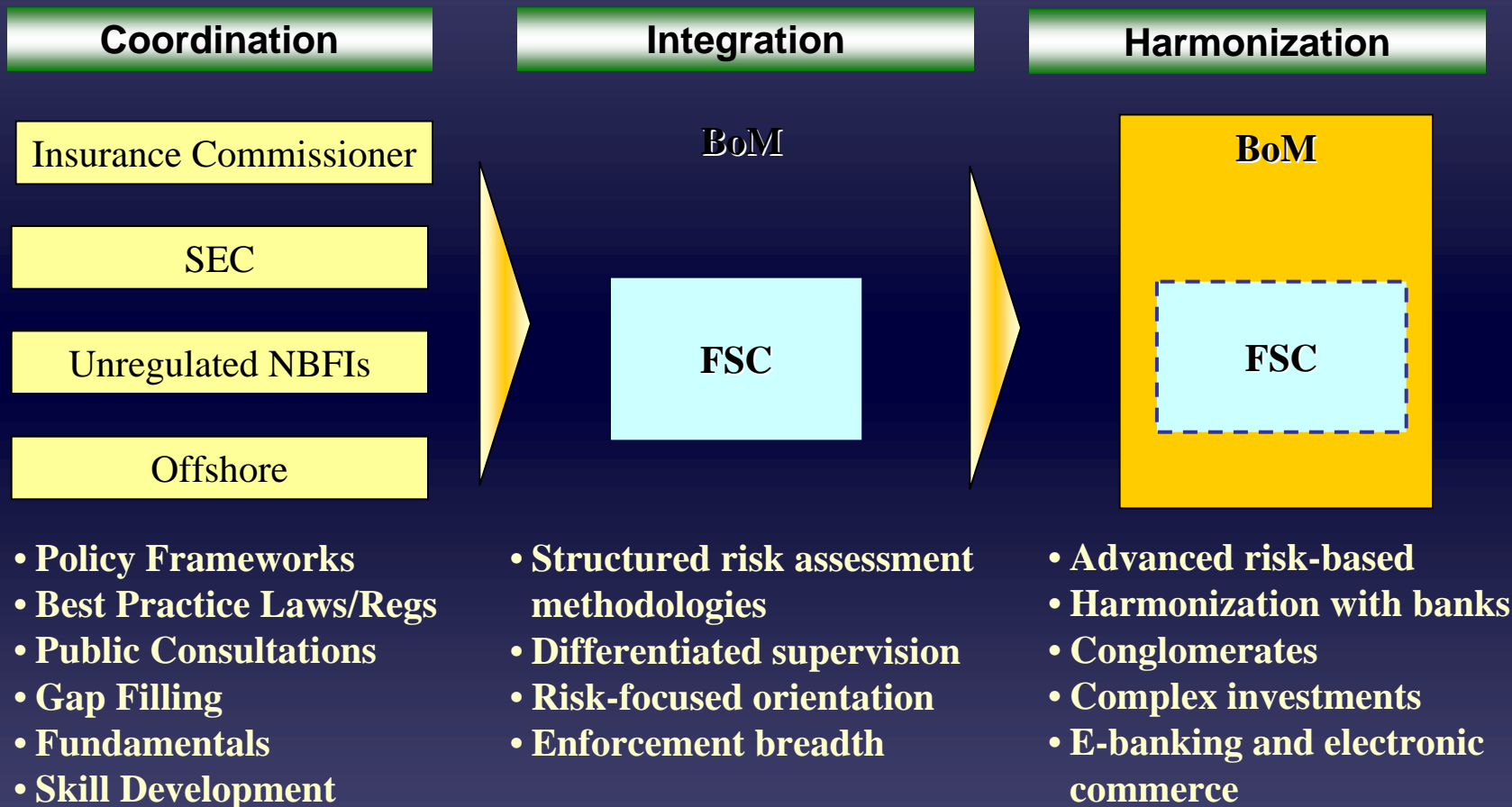
### Global Business

- Global Business Act
- Guidelines for Mgt Cos.
- Guidelines To GBC Compliance
- Guidelines for O/S Mgt Cos.
- Protected Cell Companies
- Corporate Service Providers Act (In process)*

GENERAL

- Companies Act (takeover, shareholder rights, accounting standards)
- FI & Money Laundering 2002
- Prevention of Terrorism 2002
- Trusts Acts
- Law on Contracts (used for leasing)
- Insolvency Law (In process)*
- Financial Intermediaries Act (In process)*
- Product-based Laws (TBD)*

# Program Phases



# Some Indicative Experience

- UK (BoE)
- Macedonia
- Romania

- Korea
- China (PBOC)
- Indonesia
- Thailand
- Hong Kong



- Canada (CDIC)
- US (various)
- Jamaica (Integration)

- Australia

- Argentina (Resolution)
- Ecuador (Dep Insurance)
- Brazil (Central Bank)

- Uganda (Pensions)
- Mauritius